Demolishing Farm Buildings and Structures – Any Tax Benefit?

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Overview

The acquisition of a farm or changes in the farming business may lead to the need demolish existing buildings and structures. Also, the recent major wind and rainstorm that stretched from Nebraska to Indiana damaged many farm buildings and structures that may now be irreparable and require demolition. Is there any tax benefit associated with demolishing buildings and structures? If not, perhaps it's most economical to leave unused buildings and other improvements standing.

Tax issues associated with demolishing farm buildings and structures – it's the topic of today's post.

General Rules

Capitalize into land basis. I.R.C. §280B provides that "in the case of the demolition of any structure…no deduction otherwise allowable under this chapter shall be allowed to the owner or lessee of such structure for any amount expended for such demolition, or any loss sustained on account of such demolition." Instead such amounts "shall be treated as properly chargeable to capital account with respect to the land on which the demolished structure was located." Thus, the amounts must be capitalized and added to the income tax basis of the land on which the building or structure was located. Likewise, effective for tax years beginning after 1985, it became no longer possible to receive a tax deduction for the removal of trees, stumps and brush and for other expenses associated with the clearing of land to make it suitable for use in farming. *I.R.C. §182, repealed by Pub. L. 99-514, Sec. 402(a), 100 Stat. 2221 (1986).* Accordingly, the cost of removing trees and brush, capping wells and grading the land to make it suitable for farming cannot be presently deducted. Instead, such costs are treated as development expenses (capital investment) that are added to the basis of the land.

Use before demolishing. If a farm building or structure is used in the taxpayer's trade or business of farming for a period of time before being demolished, depreciation can be claimed for the period of business use. *Treas. Reg. §1.165-3.* Upon demolition, the remaining undepreciated basis of the building or structure would be added to the basis of the land along with the demolition costs. In situations where the taxpayer purchased the property with the intent of demolishing the buildings and/or structures after using them in the taxpayer's trade or business for a period of time, the fact that the taxpayer ultimately intended to demolish the buildings is taken into account in making an apportionment of basis between the land and the buildings under Treas. Reg. §1.167(a)-5. *Treas. Reg. §1.165-3.* In this situation, the amount allocated to the buildings/structures cannot exceed the present value of the right to receive rentals from the buildings/structures over the period of their intended use. *Id.*

Abandonment. If the buildings and structures are simply abandoned, any remaining basis is treated as a disposition or a sale at a zero price. That means that the remaining income tax basis becomes an ordinary loss that is reported on Form 4797. If the abandoned buildings and structures are eventually demolished at least one year after the taxpayer ceased using them in the farm business, they have no remaining basis and only the cost of demolition would be added to the land's basis.

Demolition After Casualty

As noted above, the inland hurricane that pelted parts of Iowa and Illinois with sustained winds near 100 miles-per-hour that ultimately traveled nearly 800 miles in 14 hours, created significant damage to farm structures. When a casualty event such as this occurs, the normal capitalization rule of I.R.C. §280B does not apply when a structure that is damaged by the casualty is demolished. In *Notice 90-21, 1990-1 C.B. 332,* the IRS said that the capitalization rule does not apply to "amounts expended for the demolition of a structure damaged or destroyed by casualty, and to any loss sustained on account of such demolition." Instead, the income tax basis of the structure is reduced by the deductible casualty loss before the "loss sustained on account of" the demolition is determined. That means for a farm building or structure destroyed in the recent inland hurricane, for example, the income tax basis in the building or structure at the time of the casualty would be deductible as a casualty loss but the cost of cleaning up the mess left behind would be capitalized into the land's basis. In essence, the loss sustained before demolition is not treated as being sustained "on account of" the demolition with the result that the loss isn't disallowed by I.R.C. §280B. It's an "abnormal" retirement caused by the "unexpected and extraordinary obsolescence of the building." *See, e.g., DeCou v. Comr., 103 T.C. 80 (1994); FSA 200029054 (May 23, 2000); Treas. Reg. §1.167(a)-8(a).* Conversely, if a taxpayer incurs a loss to a building or structure and decides to withdraw a building or structure from use in the trade or business and then demolish it in a later year with no tax event occurring in the interim, the demolition costs are subject to the disallowance rule of I.R.C. §280B. *See, e.g., Gates v. United States, 168 F.3d 478 (3d Cir. 19998), aff'g., 81 AFTR 2d 98-1622 (M.D. Pa. 1998).* In that situation, the taxpayer might be able to claim a casualty loss for the year in which the loss occurred (consistent with the casualty loss rules in place at the time), and if the structure is later demolished the structure's basis must be reduced by the casualty loss that was allowed by I.R.C. §165 before the nondeductible loss sustained on account of the demolition can be determined. *Notice 90-21, 1990-1 C.B. 332*.

Tangible Property Regulations

In late 2013, the IRS released final regulations providing rules regarding the treatment of materials and supplies and the capitalization of expenditures for acquiring, maintaining, or improving tangible property (the final repair regulations). *T.D. 9636 (Sept. 13, 2013).* About a year later, the IRS issued final regulations on dispositions of tangible property, including rules for general asset accounts (GAAs) (the final disposition regulations). *T.D. 9689 (Aug. 14, 2014).* These regulations are generally effective for tax years beginning on or after Jan. 1, 2014. Under the regulations, a taxpayer generally must capitalize amounts paid to acquire, produce, or improve tangible property, but can expense items with a small dollar cost or short useful life. The regulations also provide a de minimis safe harbor that can be elected on a yearly basis to expense all items under a certain dollar cost. The repair regulations also contain specific rules for determining whether an expenditure qualifies as an improvement or a betterment (essentially following established caselaw) and provide a safe harbor for amounts paid for routine property maintenance. There is also an election that can be made to capitalize certain otherwise deductible expenses for tax purposes if they are capitalized for book purposes.

The repair/disposition regulations provide a potential opportunity for a taxpayer to continue depreciating a building/structure after demolition has occurred. Under the regulations, a taxpayer doesn't have to terminate a GAA upon the disposition of a building/structure. Thus, the taxpayer that has included buildings and structures in a GAA may choose whether to continue to depreciate them when they are disposed of (e.g., demolished) or capitalize the adjusted basis into the land under I.R.C. §280B.

The adjusted basis of any asset in a GAA that is disposed of is zero immediately before its disposition. The basis associated with such an asset remains in the GAA where it will continue to depreciate. *See Treas. Reg. §§1.168(i)-1(e)(2)(i) and (iii).* Consequently, the basis of a demolished building/structure where the cost of the demolition would be subject to capitalization under I.R.C. §280B is zero and the taxpayer can continue to depreciate the basis in the GAA. But, if only one demolished building/structure is in a GAA and the taxpayer elects to terminate the GAA, the adjusted basis of the building/structure would, in effect, be capitalized in under I.R.C. §280B. Likewise, the strategy doesn't apply if the building or structure is acquired in the same year that it is demolished or if the taxpayer intended to demolish the building/structure at the time it was acquired. *See Treas. Reg. §§1.168(i)-(c)(1)(i); 1.168(i)-1(e)(3)(vii).*

The opportunity to use the technique is further limited by a requirement that the taxpayer must have elected to include the building in a General Asset Account (GAA) in the year the taxpayer placed the building/structure in service and is in compliance with the GAA rules. The election must have been made on an original return.

Conclusion

The inland hurricane of August 10 wreaked havoc on a great deal of agricultural assets that were in its path. The tax rules surrounding the disposition of disaffected assets is important to understand.